THE RELATION BETWEEN ACCOUNTING AND CERTAIN RECENT DEVELOPMENTS IN THE STATUTORY LAW OF BUSINESS CORPORATIONS

BY

NORBERT GEORGE BAUSCH

B. S. C., Creighton University, 1932
M. S., in Accountancy, University of Illinois, 1933

AN ABSTRACT OF A THESIS

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
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THE RELATION BETWEEN ACCOUNTING AND CERTAIN DEVELOPMENTS IN THE STATUTORY LAW OF BUSINESS CORPORATIONS

This study of the relation between accounting and state business corporation laws was made upon the premise that the primary function of accounting is the presentation of accurate and informative financial reports of the activities of a business enterprise, compiled and presented to meet the needs of management, investors, and the public.[1] In carrying out this function for corporations, the accountant is frequently confronted with the task of reporting upon transactions which, although effected in a legal manner, are difficult to express in conformity with generally accepted accounting standards.

In searching for a solution, the accountant turns to the standards of his own profession as well as to those laws and rulings under which corporations are regulated. Regulation of corporate financial practices, it is found, is exercised by statutory law, by the courts, and by administrative bureaus. For this study, the business corporation laws of ten states, and of two "model" laws were analyzed.[2]

Proposals for the revision of certain financial-accounting provisions in the statutory law of business corporations should be made not only in the light of present circumstances, but also with an understanding of previous policies and changes. Therefore, a survey of some of the more important financial-accounting developments in the statutory law of business corporations from an early date (about the year 1800) is advisable.

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[1] Paton, W. A., and Littleton, A. C., *An Introduction to Corporate Accounting Standards*, Chicago: American Accounting Association, 1940 (Monograph No. 3).

[2] The statutes of the following states are included in the study: California, Delaware, Illinois, Massachusetts, Michigan, Nebraska, New Jersey, New York, Ohio, and Pennsylvania. The two "model" laws are: the Uniform Business Corporation Act, and Hills' Model Corporation Act.

From an accounting viewpoint, the earlier business corporation statutes were principally concerned with two things: (1) the establishment of an adequate amount of capital, and (2) the maintenance of that capital by prohibitions against withdrawing any part of the assets measured by the capital stock.

Efforts were made to establish an adequate capital by, (1) permitting only par value shares to be issued, (2) for cash consideration only, and (3) at a price not less than par. Provision was also made for the amount of stock to be subscribed and the capital to be paid-in before the corporation could commence business.

Limited liability, previously obtainable only by special legislative act, became a prevalent feature in corporation laws after 1850. While a fixed amount of capital stock was regarded as a substitute for unlimited liability, there was a tendency to safeguard the limited liability privilege with debt restrictions, in an attempt to give creditors greater protection. During the period 1850 to 1875, it was common to find corporate debts restricted to an amount equivalent to the "paid-in capital stock."

In contrast, developments in statutory law appeared after 1850 which reflected the emergence of the "contract theory." Characteristics of this theory are: greater freedom in drawing up the articles of incorporation, in contracting with the suppliers of capital, and in administering corporate affairs. Management sought more flexibility, particularly with reference to those transactions involving capital stock and surplus.

One of the first statutory evidences of the contract theory to affect accounting came in 1853, when New York first authorized property to be treated as valid consideration for shares. The need for greater efficiency and less expense in effecting expansion through merger and consolidation were undoubtedly the reasons for this change in statutory policy. The overvaluation problem, however, followed in its wake.

To have abolished property as valid consideration for shares, in an effort to solve the overvaluation problem, would not have been a progressive solution, for the cause lay to a great extent in the par value system itself. There is support for the belief

that the inflexibility of par values was one of the causes that led to the authorization of preferred shares (in 1865)—a special class of stock which, in its early form, resembled debt in many of its characteristics. Before this time, a corporation whose shares had a market value much below par, usually found it necessary to issue creditor obligations with fixed charges in order to obtain new funds. The effect was often an increase in already existing burdens. Preferred stock, however, could sometimes be issued on a yield basis to net par.

If the corporation had elected instead to reduce the par value of its shares to a point less than their market price, it might have faced the dilemma of being forced to discharge a sufficient amount of its debts to bring them down to the reduced capital, because of existing debt limitations. It is not unlikely that this may have been one of the causes for the disappearance of debt restrictions after 1875.

The decision in Handley v. Stutz in 1891 (139 U. S. 417), wherein the court sanctioned the sale of par value shares for a consideration much less than par (where no better price could be obtained), further emphasized the weakness of the par value system. These and other factors finally led to statutory approval of no-par shares by New York in 1912. Because the New York law required a minimum "stated" value of $5 for each no-par share issued, it injected into the no-par law some of the disadvantages of the par value system and left the way open for allocations of the consideration for such shares to paid-in surplus.

Several states followed the New York plan of adopting a minimum stated value, but the majority stipulated that the stated capital was to be measured by the consideration received. Whereas the New York plan was originally designed to insure an adequate stated capital, the stated value no-par concept was later employed as a means of providing an initial surplus, when the statutes began to permit the unrestricted allocation of consideration for no-par shares to (paid-in) surplus.

By this time (1923), a majority of the (ten) states employed a capital impairment, or net assets, test for dividends. Thus, as in the case of unrealized appraisal increases taken into the

records, the excess of net assets measured by paid-in surplus automatically became available for cash dividends. Some states corrected this deficiency by limiting the amount of consideration that might be allocated to paid-in surplus. Other states, while permitting the unrestricted allocation to paid-in surplus, restricted this source to dividends on preference shares only.

The results may at first appear to have been the same but, from an accounting viewpoint, a considerable difference is noted. Prior to this period (1923 to 1929), the prevailing common law doctrine in this country held that any impairment of capital, resulting from losses, must first be restored before dividends might be declared. However, when a state is liberal with respect to the creation of initial surplus and yet definitely and effectively restricts dividend distributions, the conclusion seems to follow that the deliberate intention is to create a "class of capital" which may be used to absorb losses without invoking the doctrine that losses should be made good before subsequent dividends could be paid. In other words, the obvious intention was to open a way for "quasi-reorganizations" without waiting for subsequent losses to produce a receivership and full reorganization.

The appearance in recent years of provisions in several statutes permitting dividends from current profits despite the existence of an operating deficit marks another departure from the doctrine that losses should first be restored. Both of these departures lack sufficient safeguards for the adequate protection of creditors and shareholders.

This expansion of the contract theory of corporate organization and administration reflects the natural conflict between the desires on the part of corporate management for greater flexibility in meeting the changing needs of business on the one hand, and the necessity on the part of the state for establishing safeguards in the public interest on the other hand.

This is perhaps best illustrated by no-par stock which was originated for the purpose of relieving the artificialities of the par value system. Mainly, through an over-emphasis of the contract theory (as expressed by stated value for no-par stock) the no-par device developed into an agency which gave manage-

ment vastly greater flexibility in financial matters than was at first apparent. Flexibility is undoubtedly desirable; informal corporate reorganization (before receivership and formal reorganization) may often be helpful. But safeguards must accompany the increased freedom to contract and administer—safeguards against ignorance as well as intended deceit.

Improvements in the financial practices of corporations and in their reporting may be brought about in a number of ways. Some safeguards could be provided by a revision of certain provisions in the present statutes. Others will no doubt be developed by the courts. Still others may properly be built up by state and Federal regulatory bureaus. Lastly, a nucleus of generally accepted accounting standards underlying corporate financial statements is being developed by the accounting profession.

Many questionable practices (now legally permissible) can be discouraged by requiring all corporations, other than those of little public interest,[3] to furnish stockholders with reliable and informative annual certified financial statements. The statutes should also specify that the balance sheet, statement of income, statement of surplus, and supporting schedules be certified by independent public accountants,[4] as in accordance with generally accepted accounting standards consistently maintained. Any deviations therefrom should be noted in the auditor's certificate. The benefits to be derived from the development of sound accounting standards will not reach their full effectiveness until it is specified by statute that they shall be employed in corporate records and reporting.

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[3] To excuse "close" corporations (i.e., those with less than twenty-five stockholders) from the requirement of financial statements would be unsatisfactory, because close corporations may be of great public interest. A better basis for ascertaining public interest and consequent responsibility for annual statements would take into consideration not only the number of stockholders, but also the number of employees and the annual sales as well.

[4] It may be pointed out that there are not enough accountants at present to meet the demand which such legislation would require. This is not a serious objection because it is not likely that all of the states would pass this type of legislation.

While the requirement of annual statements would represent a considerable advance it would, standing alone, place a very heavy responsibility on accountants for the enforcement of standards, without giving them much support. Other safeguards, in addition to the requirement of certified financial statements, should therefore be provided by statute. Those recommended are presented in the following order: (1) those involving stated capital, (2) statutory surplus and dividends, and (3) statutory net worth adjustments.

Under the laws of many states, the position of no-par preference shares is rendered unsatisfactory by the power conferred upon directors to allocate a considerable portion of the consideration for such shares to paid-in surplus. Adequate protection will be afforded such shares only when the stated capital in respect thereof is determined either, by the entire consideration for such shares, or by the aggregate of their redemption prices or liquidation preferences.

The statutes should be amended to permit only a limited portion of the consideration for non-preferences no-par shares to be allocated to paid-in surplus, and then only for a specific purpose. In view of the statutory freedom granted to management in the matter of charges to paid-in surplus, it is advisable that such surplus be restricted to an amount sufficient to meet any accumulated or near-future preferred dividends. Although the limit would be purely arbitrary, 10% to 20% would appear to be sufficient.[5] By permitting the creation of only a small initial paid-in surplus, management will (and should) be required to obtain the consent of shareholders in the event of a major capital readjustment.

The paid-in surplus problem is not associated solely with no-par shares. Large allocations may, with equal effectiveness, be made to paid-in surplus by the use of low-par value shares. For this and other reasons set forth below, it seems advisable to abolish the par value system entirely, or at least all future au-

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[5] Hills would allow 33⅓% of the consideration to be allocated to paid-in surplus. Hills, George S., "Model Corporation Act," *Harvard Law Review*, v. 48, June, 1935, p. 1360.

thorizations for par value shares, and at the same time to set up the necessary safeguards for no-par shares.

A well regulated no-par system can offer reasonable flexibility in the administration of financial matters and at the same time provide more safeguards than either the par value system alone or than a combination of both systems. It would eliminate the stock discount problem, give some relief to the over-valuation problem, and effectively control the (paid-in) surplus problem. Rather than attempt to compel corporations with par value shares now outstanding to change to no-par shares, it might be more advisable to offer some inducement to make the change. This inducement should enable the corporation to adjust its accounts in such a way as to eliminate any artificialities now existing in the accounting records as a result of the par value system. This would imply, for example, that any existing stock discount could be charged against the stated capital account of that class of shares.

Because of the competition among the states and the opposition likely to be encountered, considerable time may elapse before a complete change to the no-par system can be made. Practical attainment of a well regulated no-par system could possibly be accomplished under a Federal licensing act or a Federal incorporation act, but that subject is outside the scope of the present study. The conclusions to follow, therefore, take into consideration the possibility of the continuance for some time of the par and no-par systems.

Other safeguards are necessary for the effective regulation of stated capital. It is essential that the stated capital be accounted for separately in respect of each class of shares. It follows, therefore, that the practice of permitting paid-in surplus (or any surplus) to be transferred to stated capital, without specifying the class of shares on behalf of which the transfer is made, should be abolished.

Property and services received in exchange for both par and no-par shares should be assigned a momentary valuation by directors. The validity of stated capital would be strengthened if sworn statements as to the nature of the consideration, its value, and the process by which such value was determined

were required to be filed with the Secretary of State and the state securities commission before shares are issued. Where shares are issued in exchange for property in excess of $..... (an amount agreed upon by the legislature), the statement should be accompanied by the certificate of a qualified and disinterested appraiser. The statutes might add the provision that subsequent financial statements should be supported by footnotes as to the dollar value of property and services acquired for shares and the number and class of shares issued therefor.

There is need for distinction in the statutes between a stock dividend and a stock split-up. Provisions should be made whereby a capitalization of surplus is required as an essential part of a share dividend. It is suggested that the amount of the capitalization per share should conform to the amount of consideration that would be derived from a sale of a similar block of the shares on the open market.

Certain weaknesses and ambiguities also appear in the surplus and dividend section of present statutes and should be adjusted. Irrespective of dividend law, statutory provisions should at least be made to the effect that surplus should be classified (in the company's records and statements) in accordance with generally accepted accounting standards. This would, at present, imply a threefold classification into: earned surplus, paid-in surplus, and revaluation surplus.

It should be required that paid-in surplus be accounted for by classes of shares. This is necessary for the proper treatment of such surplus in the process of cancelation or retirement of shares. In providing for annual financial reports to stockholders, it should be required that they be accompanied by reconciliation statements reporting on the changes in the various surplus and reserve accounts. The purposes of a surplus classification are largely defeated if the corporation is required to report only the net balances of the several surplus accounts.

The dividend section of the statutes should be made to conform more closely with accepted accounting standards. The "excess assets" concept of dividends, now found in many states, should be replaced with a "surplus profits" concept, modified somewhat perhaps in order to provide flexibility in meeting

unusual situations. The following suggestions, representing a composite of the opinions of various legal and accounting writers, are offered as a starting point for further study.

(1) No cash dividends shall be declared on common shares except from earned surplus. Earned surplus shall be interpreted to include the profits of the accounting period just ended and accumulated undistributed profits, computed in accordance with generally accepted accounting principles and standards consistently maintained.[6]

(2) Cash dividends may be declared out of paid-in surplus on behalf of cumulative preference shares (with or without liquidation preferences), but only in the absence of earned surplus. In the event of the existence of an operating deficit, such dividends shall not reduce the balance of paid-in surplus below an amount equal to the operating deficit. Such dividends should be accompanied by a notice of the source from which they were paid.

(3) Cash dividends on cumulative shares with liquidation preferences may be declared from current profits in spite of an operating deficit, subject to the following restrictions: (a) the amount of the dividend shall not exceed two-thirds of the current profits earned during the preceding accounting period, which shall not be less than six months nor more than one year in duration, and (b) the book value of the net assets (exclusive of appreciation) after the proposed dividend shall be at least equal to the sum of the aggregate amount of the liquidation preferences and an amount equal to one-half of the remainder resulting from subtracting such aggregate amount of the liquidation preferences from the amount of the stated capital of the corporation.[7]

(4) No dividend shall be declared when there is reasonable ground for believing that the payment thereof would render the corporation unable to satisfy its determined and contingent debts and liabilities when they fall due.

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[6] Littleton, A. C., "Business Profits as a Legal Basis for Dividends", *Harvard Business Review*, v. 16, No. 1, Autumn, 1937, p. 60.

[7] Paragraph (3), with modifications is taken from Hills, George S., *op. cit.*, p. 1364.

(5) Dividends payable in shares may be declared only from earned surplus, or from revaluation surplus arising from bona fide appraisal increases. Share dividends from revaluation surplus should be accompanied by notice of source. Paid-in surplus represents the capital contributions of already outstanding shares and, if it is capitalized, the transfer should be made to stated capital by resolution of the board of directors and not by a share dividend.

(6) Dividends from depletion reserve may be permitted, but with the following safeguards: (a) the company must be engaged solely or substantially in the exploitation of mines, oil wells, gas wells, patents, or other wasting assets, (b) adequate provision shall be made for meeting debts and the liquidation preference of any such outstanding shares, (c) notice shall be given to shareholders as to the source of the distribution, and (d) earned surplus must first be exhausted.

These safeguards would insure protection to creditors and shareholders, and yet would not hamper honest financial practices.

The third group of legislative recommendations pertains to treasury share acquisitions, capital distributions and statutory net worth adjustments. Most states provide that the aggregate cost of treasury shares held by the corporation should not exceed the amount of net assets legally available for dividends. Appraisal surplus is not a proper source for treasury share purchases because of its unrealized character. Likewise, from a regulatory viewpoint, paid-in surplus is not a desirable source since it is itself essentially contributed capital, the very item which law is interested in conserving. It follows, therefore, that purchases of treasury shares should be limited by statute to earned surplus.

Existing statutes are lax with respect to stated capital reductions. And yet, any proposal to limit such reductions is confronted by the fact that a satisfactory proportion of corporate debts to stated capital is a highly varied matter as among different types of corporations. Another difficulty is that such limitation might preclude a reasonable capital readjustment pro-

gram. It is recognized, however, that unless some minimum is adopted, the stated capital may be reduced to a mere nominal amount. It is suggested that the limit to which stated capital may be reduced should be the higher of either of the following: (1) one-third of the corporate debts and liabilities, or (2) the aggregate amount of the liquidation or redemption prices of (no-par) preferred shares, plus the aggregate stated capital of non-preference (no-par) shares outstanding after the reduction.

Some states are silent as to the disposition of surplus created by a reduction of stated capital. Others expressly permit it to be used for the reduction or elimination of any deficit arising from operations or losses sustained. No further safeguards are added. Of the ten states studied, California alone effectively requires a full disclosure of the adjustments in the next annual statement and at the next annual meeting of shareholders.

This disclosure, however, is only a minimum safeguard. A standard of good practice would require that, in addition to approving the stated capital reduction, shareholders also approve the rest of the adjustment program (at least in its broad outlines). It is undesirable at present for statutes to prescribe the specific accounting standards of capital readjustments. It would be better if the statutes merely provided that a corporation observe generally accepted accounting standards in the readjustment program.

For those cases in which a stated capital reduction is accompanied by a distribution of assets, Section 348b of the California Corporation Law may (with one qualification) be regarded as the model. If any preferred shares are outstanding, no payment can be made to common shareholders until the preferred is first retired. In addition, the board of directors is required to state, under oath, that the corporation will not be rendered unable to meet its debts as they mature, and that the *fair present value* of the remaining assets is at least equal to one and one-quarter times the known debts. It is suggested that a margin of assets over debts of one-third rather than one-fourth would give added safety to creditors without hampering legitimate distributions to shareholders.

As was stated above, some safeguards not yet appropriate for statutory law will be erected by the slow process of common law. One illustration of common law development of no-par matters deals with the consideration for no-par shares and the relation of such consideration to stated capital.[8] This aspect of no-par shares, however, has not been satisfactorily settled by the courts. Additional safeguards relative to the price at which no-par shares can be sold, to the valuation and adequacy of consideration in kind and the relation of these factors to stated capital, must come from further developments in the common law. This applies also to certain aspects in the reduction of stated capital upon the retirement or cancellation of shares, and to the development of safeguards in asset distributions and quasi-reorganization.

Federal and state securities laws and their related administrative bureaus are primarily designed to provide present and prospective investors with dependable, relevant information as to the financial condition and earning ability of companies soliciting funds. Their primary function is not that of regulating the financial affairs of corporations. Consequently, they supplement statutory law and the courts by providing safeguards through the requirement of disclosure of corporate transactions in the form of financial statements and reports.

Some state securities laws and administrative bureaus are reasonably effective; others are lax; and in several states they do not exist. The most effective bureau is the Securities and Exchange Commission. This administrative bureau is in a position to lend the weight of its authority to generally accepted accounting standards. In cases where financial statements filed with the Commission are prepared in accordance with opinion for which there is little or no support (other than the fact that it is legal under the particular business corporation statute), such financial statements are held to be misleading, if the matter

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[8] Bodell v. General Gas and Electric Corp., 15 Del. Ch. 119, 132 Atl. 442, affirmed 15 Del. Ch. 420, 140 Atl. 264 (1926) fair price for no-par shares; American Refining Co. v. Staples, (Tex. Civ. App.) 260 S.W. 614, 36 A.L.R. 793 (1924) liability of no-par shareholders—dividends in case of no-par stock corporations.

involved is material. This attitude is taken despite disclosure in supplementary notes. The only choice, where generally accepted accounting standards have been violated, is an amendment of the financial statements.[9]

Several matters which the Commission has enforced will illustrate its part in setting up safeguards in corporate reporting. Where shares are issued for property or services, the Commission requires a complete disclosure as to the basis for valuing such consideration, its nature, and an accurate description thereof. The concealment of questionable charges for promoters' fees and other intangibles in the property accounts has thus been materially reduced. Another example has been the insistence of the Commission on a clear presentation of corporate net worth. Each class of stated capital is required to be set forth separately. Surplus, wherever conditions will permit, is required to be classified and elsewhere analyzed in detail. Where the equity of preferred shares with liquidation preferences exceeds the net assets, such facts must be shown. A third set of safeguards has been enforced in capital readjustment programs. Pressure is exerted to compel the management to seek shareholder approval of the readjustment program by enforcing the penalty of frank disclosure and complete analysis of the implications of the program, in the event of failure to solicit such shareholder approval. The Commission requires that the earned surplus must first be exhausted by charges before recourse may be had to paid-in surplus. Writedowns are to be complete but fair, only losses actually sustained shall be recognized, and subsequent earned surplus must be dated.

On the above matters accounting opinion is generally well crystallized and the Commission is insistent upon their application. However, where there is a conflict of accounting opinion, *i.e.*, where there is also substantial authoritative support for the legal minimum, the Commission will accept disclosure in lieu of a correction of the financial statements. In the latter event, it is required that the accountant's certificate contain a comment as to his opinion on the controversal question. Thus the Securi-

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[9] Securities and Exchange Commission, Accounting Series, Release No. 4, April 25, 1938.

ties and Exchange Commission, through the medium of its control over the financial reporting of registered companies, provides numerous safeguards for the protection of corporate creditors, shareholders, and the general public.

A fourth source of safeguards is furnished by the accounting profession. As was mentioned earlier, some accounting standards are suitable for enactment into the statutes and others are not. There are several reasons why this condition prevails. By their nature, business corporation laws set a minimum of financial practice which must be observed in order to avoid a penalty. In very few respects are they guides to good practice. In many instances they present a dividing line between acceptable and irregular financial practices.

They are essentially a minimum and not a standard of financial practice. Accounting, on the other hand, is not coercive and is not designed to punish violation. Consequently, its rules are not confined to the minimum but rather to a standard of good practice. Its function is to report financial transactions accurately and truthfully, rather than to regulate them. Because of the minimum character of the statutes, the responsibility falls upon accounting to erect additional safeguards when provisions in the statutes may be fulfilled, though the full truth be clouded or concealed.

A second need for accounting standards, separate from statutes, arises from the necessity for accounting to meet new problems as they arise. A solution for new problems must be found without undue delay; much time must elapse before statutes and court decisions can give recognition to new problems and questionable practices.

Thirdly, it would be unwise to enact a mass of accounting details or opinions into strait-jacketing, statutory form. Business corporation laws, for example, should not contain complex procedures for the determination of accounting profit. It is preferable that the accounting profession develop its own unified, coherent, and practical set of standards for the determination of accounting profit. The statute could then provide that profits available for dividends shall be determined in accordance with generally accepted accounting standards consistently maintained.

Only those accounting standards on which there is general acceptance among accountants and wide usage in business over a long period of years may be considered as possible materials for statute law.

For a similar reason, it would not be advisable to enact into statutory form the accounting standards to be observed in carrying out the readjustments in quasi-reorganization. It would seem more advisable that the statute specify that generally accepted accounting standards shall be followed in carrying out the capital readjustment program.

It is not to be supposed, however, that it is possible to include as a part of each statutory section, governing a specific financial practice, a stipulation to the effect that sound accounting standards shall be observed. It was pointed out above that statutes, because of their punitive nature, must frequently prescribe a minimum of practice. Accounting rules and procedures, on the other hand, are standards of good practice. There are other accounting standards, relating to charges and credits that may properly be made to stated capital or a particular surplus account, which are not suitable for statutory enactment. Several pertinent to this study are reviewed briefly.

While law regards the cost of treasury shares as a reduction of (earned) surplus, for accounting purposes the cost of such shares may be treated as an unallocated reduction of stated capital and surplus. Accountants, however, should recognize the legal aspect of treasury shares by earmarking that surplus from which the purchase was legally made for the amount restricted thereby. Furthermore, so-called "gains" from the resale of treasury shares should be credited to the paid-in surplus of that class of shares.

There is no provision in the statutes of the ten states studied which would prevent a corporation from charging paid-in surplus with either, (1) the premium paid to preferred shareholders upon redemption, or (2) any expenses incident to redemption. Good accounting standards, however, require that paid-in capital" shall be reduced only to the extent of the proportion thereof represented by the shares so cancelled or retired. The same principle would apply in the event of the retirement or

cancellation of treasury shares.

Although accounting standards with respect to proper charges and credits to state capital are fairly well crystallized, many of those relating to surplus are still in controversy. For example, no final solution has been advanced as to the proper disposition of revaluation surplus once it is entered on the records. Nor has general agreement been reached as to all legitimate charges and credits to paid-in (capital) surplus. A few of the legitimate surplus charges and credits upon which opinion appears to be crystallizing may be mentioned briefly. Appraisal surplus created by the write-up of a group of like assets may subsequently be charged for the loss incurred upon the abandonment of that same property, but it does not follow that the same appraisal surplus may instead be charged for the abandonment losses of other non-appraised assets of a different group. Likewise, the subversive practice of setting up reserves for operating losses out of paid-in or revaluation surplus, with the intention of relieving the current or future income account of these charges, has been condemned by the accounting profession and the Securities and Exchange Commission.

The accountant can no longer be guided alone by what appears to be permissible under the statute, for the reason that he is responsible to investors as well as the management. In those instances where following the statutory minimum produces a practice that conflicts with generally accepted accounting standards, it is the accountant's duty to insist upon the application of the accounting standard. Where, however, honest difference of opinion still exists, the less desirable alternative may perhaps be followed if the accountant's powers of persuasion fail. In such cases, it is his duty to, (1) insist upon a full disclosure of the facts in the statements, and (2) at the same time to state, in his certificate, his opinion on the controversal matter.

In conclusion, it is recommended that the following actions be taken in order to provide a better system of safeguards for corporate financial practice and reporting.

(1) An immediate need is a statutory requirement for annual certified financial statements. The auditor's certificate should disclose the scope of the examination, and contain a statement

to the effect that generally accepted accounting standards were consistently followed.

(2) Those provisions in the statutes, the nature of which is such as to cloud or hinder the portrayal of truth in the financial statements, should be amended. It need not be the primary intention of such revisions to raise the level of financial practice under the statutes, except in so far as a more adequate disclosure will curb questionable practices.

(3) If financial statements and reports are to serve useful purposes in furnishing intelligible information to stockholders, investors, and regulatory commissions, it is necessary that generally accepted standards be consistently employed in the preparation of the statements and in the books of account. Although much has been done toward reformulating accounting principles and standards, conflicting opinions and alternative practices still persist. New conditions and new financial devices will undoubtedly raise further questions and necessitate continuous research in the development of acceptable standards. Such initiative on the part of the accounting profession will avoid the possibility of, or the necessity for, agencies less qualified by training and experience to develop accounting standards according to their ideas.

(4) Finally, there is a need for accountants to participate (in an advisory capacity) in the amendment of existing laws and in the enactment of new laws, with a view of raising the level of financial practice now permitted. Accountants should become more familiar with the financial-accounting phases of the statutory, administrative, and case law of corporations. They are in a position to advise the drafting committees on the financial and accounting implications of certain statutory provisions which ordinarily would not be evident to the legal expert.

Accounting cannot satisfactorily enforce practical and adequate safeguards without the aid of law, nor can statutory and administrative law provide satisfactory legal standards of financial practice without calling upon accounting. Out of a mutual cooperation of the two groups, a system of reasonable safeguards, simultaneous with adequate management flexibility, can be constructed.

VITA

Norbert George Bausch was born on September 23, 1909, in Ashton, Iowa. He attended St. Joseph's School and was graduated from St. Joseph's High School in 1927. In September, 1928, he entered Creighton University, and in June, 1932, received the Bachelor of Science in Commerce degree, with a major in accountancy. At that time he was awarded the Delta Sigma Pi Scholarship Key. The following September he entered the University of Illinois, and, in 1933, received the degree of Master of Science in Accountancy. His graduate studies were continued until September, 1934, at which time he accepted the position of Instructor in Accountancy at St. Viator College, Bourbonnais, Illinois. The following year he joined the faculty of the College of Commerce at Creighton University, Omaha, Nebraska, where he now holds the position as Instructor in Accountancy.